

ACCOUNT ADMINISTRATION: PERSONAL AND CHARITABLE ACCOUNTS

The services defined below are commonly found in the majority of trust departments and the described duties are usual. Duties normally accompanying acceptance of the described capacities vary between states. For this reason, they are described in general terms. In order to gain a more complete understanding of the scope of the duties and responsibilities of a given fiduciary capacity, it is recommended that examiners be familiar with applicable state statutes.

A. EXECUTOR

An executor, whether an individual or an institution is nominated in a will by the maker (testator) to settle an estate and to perform in any other manner described in the will. Before a bank acts as executor, it must have the will accepted by a court of competent jurisdiction as the valid and final will of the deceased and receive written authority from that court to serve as executor.

The main duties of the executor include the following: Assembling of testator's assets; Preparation of an inventory of all assets of the deceased; Taking control or custody of such assets; Orderly conversion of certain assets "in kind"; payment of administration costs, taxes including Federal estate and State inheritance taxes when applicable, and all other claims according to law; Distribution of the net remaining estate in accordance with the terms of the will; and Filing of a final accounting with the court of competent jurisdiction if required. Probate procedures, including any requirement for interim accountings, vary between states.

B. ADMINISTRATOR

An administrator is appointed by the court to settle the estate of a person who died leaving no valid will. The chief difference between the duties of an administrator and an executor is that the latter functions under the provisions of a will whereas the former functions without a will in accordance with the intestacy laws of a state.

C. ADMINISTRATOR C.T.A.

The court appoints an administrator c.t.a., with the will annexed, when no executor has been named in the will or when the executor has died or is unable or unwilling to serve. The duties of an administrator c.t.a. are the same as those of an executor; distribution of the property is made in accordance with the terms of the will. When an executor or an administrator c.t.a. dies or is removed before completing the settlement of the estate, the substitute fiduciary is known as an administrator c.t.a.d.b.n., i.e., administrator with the will attached for assets not yet distributed.

D. TRUSTEE UNDER WILL

A trust under will is created when the maker of it will leaves any portion of his estate to an individual or bank as a trustee for a person, corporation or charitable organization rather than leaving the property outright. The trustee receives the property from the executor or administrator, administers it for the benefit of the beneficiaries named in the will, and makes the ultimate distribution directed in the will. The bank frequently, may first be executor (or administrator c.t.a.) and then follow as trustee if the will establishes a trust and the court permits by necessary appointment.

E. TRUSTEE UNDER AGREEMENT OR BY DECLARATION

A trust under agreement comes into existence when the creator of the trust enters into an agreement or contract with the trustee setting out the terms of the trust. A trust by declaration is created upon declaration by one person to be trustee of the property for someone. Duties are those specifically set, out in the agreement or declaration and may include a wide range of responsibilities. These trusts are often referred to as inter-vivos trusts. The creator may have reserved the right to amend these agreements, in which instances the agreements are considered either partially or fully revocable. Irrevocable forms of agreement are also used and may have certain tax advantages.

The operation of the Federal income tax law has led to the creation of special purpose irrevocable trusts for individuals. The most notable example is the "Clifford Trust" which generally grants the creator taxpayer some Federal income tax relief.

F. CHARITABLE TRUSTS

A charitable trust may be established by will or agreement for religious, educational, cultural or community-welfare purposes. It is normally exempt from Federal income tax if it meets the requirements of the U.S. Internal Revenue Code. In many states, the rights of the charitable beneficiary are enforced by the attorney general of that state. Ordinarily a charitable trust can last forever, but duration of other trusts is limited by the rule against perpetuities which differs in important respects from state to state. The purposes for which charitable trusts are established depend upon the intent of the trustor. Charitable trusts may be further segregated into:

Community Trusts - A community trust is composed of gifts and bequests made by individuals or corporations for the benefit of the people of a community defined in the broadest manner, including a city, town, county, state, nation or even the world. Many advantages exist in using a community trust to handle funds, primarily that maximum benefit is received by the people of the community. However, a bank must realize need for wisdom and careful propriety in distributing the benefits of a community trust.

Institution Trusts - Included in this category are trusts for the benefit of higher educational institutions and other public organizations devoted to the arts, health and the sciences. Examples include art galleries, symphony orchestras, libraries, hospitals and churches. Whereas in the case of community trusts the beneficiaries are varied and often unspecified, institutional trusts are created for the specific benefit of the object served by the institution. The responsibilities of the bank may range from limited agency to full discretionary trust management.

G. CHARITABLE CONTRIBUTION "CLIFFORD TRUSTS" FOR BANKS

This special purpose account combines charitable features with the customary Clifford Trust, a form of personal trust created for a period exceeding ten years. The creator of such a trust transfers assets irrevocably in trust and, if applicable provisions of the Internal Revenue Code are satisfied, the income is not taxable to the grantor during the term of the trust. The income may or may not be used for charitable purposes.

A bank sometimes establishes a Clifford Trust

itself primarily for income tax purposes. Under the Internal Revenue Code, a corporation is restricted to a maximum percentage of its taxable income that may be deducted as a charitable contribution. By utilizing this form of trust, a bank may increase its charitable contributions to more than the limited percent of taxable income without the excess subject to taxation. The trust is funded with bank assets, usually cash or prime-quality securities, and all of the income is distributed to charities, with the principal reverting to the bank at termination of the trust. One or more of the bank's directors and/or officers may be appointed as individual trustee(s). In such cases, the bank does not need trust powers. However, if the bank has a trust department it would be preferable for that department to be named as trustee.

The amount to be contributed to the Clifford Trust and the trust instrument should be approved by the bank's board of directors with such approval noted in the minutes. The board should also review and officially approve any periodic accountings. The trust instrument should also be reviewed and approved by competent legal counsel. Compliance with applicable state law should be determined with a written opinion from the bank's tax advisor confirming that Internal Revenue Service criteria have been met. While not mandatory, it is considered prudent for the bank to obtain a Private Letter Ruling as to the Clifford Trust's status under the income tax and gift and estate tax provisions of the Internal Revenue Code.

The trust instrument should: Provide a statement of the purpose and objective of the trust; specifically prohibit "insider" transactions, self-dealing and conflicts of interest; provide for disclosure of the trust's operations to the FDIC and State banking authority; and require periodic (at least annually) accountings to the board of directors. The trust instrument should not include any authority which might allow the trust to borrow funds or to permit trust assets to be mortgaged, pledged or otherwise encumbered.

A bank's current and projected liquidity, its future earnings and the adequacy of its capital are impacted by a Clifford Trust arrangement. The irrevocable nature of the trust precludes the use of the trust's assets for bank liquidity purposes at the time of their donation and throughout the trust term. Bank earnings are diminished by the loss of

the revenues generated by the assets contributed to the trust which, in turn, impacts the bank's capital position. It should be noted that no deduction is made from a bank's capital for the assets donated to the trust as they are simply removed from the appropriate asset category on the bank's books and transferred to an appropriately captioned other asset category. In light of these considerations, it seems reasonable to expect a bank to be able to project that such a Clifford Trust will have no serious adverse impact on its capital, liquidity and earnings during the term of the trust.

H. TRUSTEE BY ORDER OF COURT

A court of competent jurisdiction may appoint a bank as trustee to receive property in trust and administer it for the benefit of the person(s) designated. Many trust relationships so established are in the nature of a guardianship. In some states the capacity is known as a guardianship of conservatorship rather than trusteeship. Often, the court appoints the trustee for a special purpose arising from litigation in court. In divorce proceedings or real property disputes, the court may appoint a trustee to care for property and account to beneficiaries pending settlement of the ownership dispute. The trustee in this instance may have full or only directed authority over the management of the disputed property.

One of the most important responsibilities of a trustee, whether acting under a trust, whether acting under a will, agreement or court order, is to follow an investment program that will afford the income beneficiary a reasonable yield and yet assure the remainderman or principal beneficiary an adequate degree of safety of principal. The types of investments a trustee may purchase or retain if received in kind, are usually prescribed by the governing will, trust agreement, court order, or by state statutes and the decisions of local courts.

I. GUARDIAN

A guardian is an individual or institution appointed by a court to care for the property or the person (or both) of a minor, an incompetent, a spendthrift, or other incapacitated person. The duties and responsibilities of the guardian are governed by the provisions of state statutes and interpretations by the courts. The guardian's

duties may be limited to the property (guardian of the estate), limited to the person (guardian of the person), and when applicable to both (guardian). Banks generally will serve only in the capacity of guardian of the estate. A guardian is an agent of the court and has no legal or equitable title to the ward's property. The guardian of a minor receives, holds and manages the property, renders accountings to the court and makes a final settlement with the minor when he becomes of age. A guardian for an incompetent or absentee performs the above duties as long as the incompetency or absenteeism last. Such words as committee, conservator, curator and tutor are used in various states to describe particular kinds of guardianships.

J. CO-FIDUCIARIES

It is important to note that in each of the aforementioned capacities the bank, in accordance with the governing instrument or appointment, may be required to administer the account along with a co-fiduciary. A co-fiduciary may be one or more individuals or another bank or trust company. Usually the co-fiduciary is another individual and the bank is now referred to as the corporate fiduciary. This is not to be confused with the function of a Corporate Trustee who is responsible for debt issues of corporations and is described under Section VI of this Manual. A testator or creator of a trust may wish to provide special expertise over investments or be assured that certain family interests are considered when decisions are made regarding the account. Therefore, a co-fiduciary is named in the instrument. A court may appoint a co-guardian for similar reasons or more commonly appoint a guardian of the person while the bank acts as guardian of the estate. It is generally held that co-fiduciaries act in unison. The examiner should determine that the bank has documented approvals from co-fiduciaries for all investment transactions and other discretionary decisions affecting account administration. These approvals should be in written form and kept as part of the permanent file documentation. It is generally undesirable for an individual co-fiduciary to have possession of assets. When this occurs, the examiner should evaluate the controls over these assets and any bonding requirements applicable to the individual fiduciary. The examiner needs to determine if the bank has delegated excessive authority over investments or other matters to the individual

co-fiduciary. The courts will generally allow a bank or trust company to serve without bond, normally required of an individual.

K. AGENCIES

Agency accounts are those in which title to the property managed does not generally pass to the trust institution but remains in the owner of the property known as the principal, and in which the agent is charged with certain duties with respect to the property. In certain instances such as conventional managing agency accounts, the agreement provides for assets to be titled in the name of the bank or its nominee in order to expedite trading activities. A bank acting as an agent should always operate under a written agreement with the principal and confine its activities to those specifically authorized. Either the principal or agent can normally terminate the relationship. However, it will automatically terminate at the death of the principal. There are many kinds of personal agencies under which a bank may serve as agent for the principal; Custodianship, Escrow Agent Investment Advisory Agent, Managing Agent, Attorney-in-Fact, and Safekeeping.

In a Custodianship, the bank has only the duties of safekeeping the property and performing ministerial acts as directed by the principal. As a rule, no management or advisory duties are exercised. For example, in the exercise of custodial duties involving securities, the bank may be required to collect income and principal, notify the principal of default, called securities, stock rights for purchase, etc., and to execute the owner's orders to buy and sell agency property.

In its capacity as Escrow Agent, a bank has the responsibility of holding the assets and other documents delivered into its custody until the conditions for their release to a third party have been fulfilled in accordance with the terms of the escrow agreement. Thus, to its custodial duties are added the responsibilities of seeing that the conditions specified by the principal in the manner intended before the assets and other documents are delivered to the third party. This makes the bank liable for its actions not only to the principal, but to the third party. Care should be taken to determine that the bank as escrowee assumes no undue liability under the terms of the agreement, its duties and obligations are clearly set forth, and it is not placed in the position of

arbitrator.

As Investment Advisory Agent, the bank may exercise a number of duties, one of which will probably be the making of investment recommendations to the principal. Other duties may include execution of security transactions, collection and disbursement of income, and other custodial duties. Generally, written approval of the principal is needed for investment transactions and disbursement of funds and/or assets.

As Managing Agent, the bank usually has the same basic duties as when it acts in an investment advisory capacity, together, generally, with the authority to make investment selections and execute transactions without the written consent of the principal. Modern management agency agreements are general in language and some give great discretionary authority. While a managing agency may seem similar to a trust relationship, property title and account termination differ. In an agency relationship, title to the property remains with the principal and the agency relationship terminates upon revocation by either party or at the death of the principal.

A bank becomes Attorney-in-Fact when it receives a formally executed power of attorney which may or may not be recorded as a public record. Usually there is a written agreement defining the areas in which the bank may seem as attorney-in-fact for an individual. Without such limitation, the bank may do anything as attorney-in-fact which the principal could have initiated; vote stock, sign or endorse checks, sign proxies, collect debts, convey real estate, transfer personal property, or perform similar services. In some jurisdictions, an inoperative attorney-in-fact account is utilized by a customer and the bank as a means to avoid a guardianship appointment in anticipation of a customer being declared incompetent.

A bank performs Safekeeping duties when it accepts property for safekeeping only and delivers the property to the principal or others as the principal may direct, with no ministerial action taken or required during the period of safekeeping. The examiner should determine that the safekeeping division of the trust department maintains adequate records and controls and suitable physical security. Articles left for safekeeping should not be commingled with bank

assets but should be property earmarked and protected by ample insurance.

L. ADMINISTRATION

In the administration of its personal trust business, a fiduciary should provide reliable and prudent business and financial service including timely personal service to beneficiaries. The fiduciary in accepting business must determine that personal trust service is needed and such service can be effectively rendered. The intent of the testator, creator or principal must be understood by the trust administrator to enable the purpose and objective of the account to be fulfilled. It is the fundamental duty of a fiduciary to administer an account solely in the interest of the beneficiaries without permitting the interests of the trustee or third parties to conflict in any manner. This precept of undivided loyalty is of paramount importance and underlies the entire administration of personal and charitable accounts. A successful administration will meet the needs of beneficiaries in a safe and productive manner while equitably balancing the interests of each beneficiary.

M. APPLICABLE LAWS AND REGULATIONS

Trust activities are governed by both common law and Federal, State and local statutes and regulations, with common law much more voluminous and detailed. The examiner should have at least a general familiarity with some of the more widely known authorities such as Scott, Bogert and the Restatement of the Law of Trusts, which deal primarily with common law. While the examiner is not expected to be an authority, some of the more basic common law principles can be researched and cited. It would be most unusual to cite a "violation" of common law (equity). This would usually be treated with a reference to "generally accepted trust practices". Noncompliance with common law may involve a substantial exposure to liability and loss, while violation of a statute may be only a technical matter with little or no financial exposure. Applicable statutes are to be observed by the institution and any violations identified are to be scheduled in the report of examination citing the section of law contravened. Noncompliance with certain principles of equity, such as well-settled local case law, would normally, be treated as an other criticized matter rather than a statutory violation. There can be an overlap when there are

court decisions covering the specific application of certain statutes. Few examiners are qualified to render a legal opinion as to equity matters involved in the administration of personal and testamentary trusts. However, a reasonably trained and experienced examiner should be able to set out the facts where there has been an apparent violation of equity or of the trust instrument itself, with an estimate made as to the possible financial consequences to the bank. In large, complex and serious matters, the bank's legal counsel (house or outside) may be requested to give an opinion on the matter.

The administration of personal and testamentary trusts, court appointments, agencies, and similar functions is covered by statutes relating to the function itself, as well as statutes covering the property administered. The performance of fiduciary functions is subject to parts of the United States Code and to other laws, acts and executive orders of the Federal government. Some of these relate to the performance of the function itself, such as Federal banking laws relative to trust powers, others cover some of the activities incidental to the function. For example, in the conduct of a trust business the trustee is required to comply with Federal securities laws, consumer protection laws, the Federal Reserve Act and Regulations, fair credit laws, Treasury regulations, the Internal Revenue Code, etc. Some of these have specific references to the activities of a trustee or other fiduciary, other apply by reason of the property owned and administered by the trustee. A fiduciary is as subject to these laws as any individual or business entity owning and dealing with property, and a violation of any of them is a statutory violation to be reported.

State financial codes, generally part of the codified statutes, will usually contain laws covering banks, trust companies and similar institutions. As seen when Federal banking laws discussed previously, State codes also apply both directly and indirectly. They are the most direct reference to trust activities and if a state has specific requirements to qualify for chartering and operating a trust department, they will be covered in these codes.

In some states rather extensive laws cover operation of a trust company which by reference includes the operation of the trust department of a State-chartered bank. They might include such things as requirements for a pledge of assets,

qualifications for directors or officers, standards for accounting, required reports and similar matters. Sometimes other sections of the financial code besides the banking code will apply. Bank and nonbank trustees may be subject to such things as required bonding, reporting to the courts, limitations on types of investments that may be made and similar restrictions. A growing number of states have adopted various uniform statutes that apply directly or indirectly to the conduct of trust business such as a Uniform Probate Code, Uniform Principal and Income Act, Uniform Gifts to Minors Act, Uniform Common Trust Fund Act, Uniform commercial Code, Uniform Simultaneous Death Act, the Prudent Man Rule and similar statutes. State laws that apply to classes of property also are relevant. For example, real property held as an asset of a trust or estate would be subject to state real property laws.

The creation of many trusts results from tax planning by a trustor. Examiners should be mindful of this fact but are not expected to interpret tax law. Examiners should question the administration of an account where it appears that a trustor's tax objectives may be undermined by flagrantly faulty administration.

Obviously examiners cannot evaluate a trust department's compliance with all aspects of Federal, State and local laws. First consideration should be given to directly applicable Federal and State laws covering the conduct of a trust business, particularly those for which the regulatory agency has primary enforcement responsibility. Nonconformance with other laws and regulations would be viewed in light of the possible effect: on the condition and operation of the department. If the violation is a type that could expose a bank to significant problems, such as liability/loss or civil/criminal penalties, it should be scheduled and treated in detail. Similarly, if there is a pattern of disregard for applicable laws and regulations that would reflect on management's competence, it should also be detailed in the report of examination.

N. EXAMINATION PROCEDURES

In small departments, each new trust account accepted since the last examination should be reviewed to ascertain that the original corpus was properly and accurately entered on the department's records and placed under

appropriate control. The review should encompass consideration of all discretionary or court ordered administrative or investment activity since acceptance. In larger institutions, time and manpower constraints necessitate that thorough determinations and reviews be limited to a sampling of trust accounts.

A review should be made to determine that income is being received for trust accounts. The examiner must be satisfied that the trust department is properly recording all income received and adequately checking the receipt of such income, not only to prevent dishonesty but eliminate error. Proof of subsidiary records to the general ledger should be effected. The detailed verification of the items of income depends upon the size of the department and the effectiveness of accounting practices of the bank in controlling all income. As conditions warrant, either "spot-checks" should be made or a complete verification performed. The auditing technique employed involves determination of income amounts and dates from the asset records and the tracing of the actual collection from receipt through the books of original entry to the general ledger.

Having reviewed income, the examiner should determine that disbursements and expenditures are made in conformity with the fiduciary agreement and applicable statutes. Improper distribution or payment of funds from fiduciary accounts may result in loss to the bank. All disbursements and expense payments should be made by distinctive check or voucher. Both the agreement and statutes may have to be examined to determine the manner in which special dividends or stock dividends are allocated or apportioned between principal and income. This is important in cases where the income and principal beneficiaries are different or where only income is available for distribution. The examiner should be sure sound internal controls are in effect for the payment of expenses. The administrative officer authorizing payment should not have access to the actual checks nor be involved in the reconciliation or review of the department's transactions deposit account(s). The bank's auditing program should call for periodic review of the documentation supporting expense items and some direct verification of disbursement.

Overdrafts or advances to an account occur

whenever disbursements exceed the cash balances available in either the principal or the income of the account. The examiner should determine "true" overdrafts. A "true" overdraft exists only after credit has been given for any available offsetting balances and an overdrawn condition remains. Offsetting balances may be immediately available in those accounts where principal and income may be invaded for the benefit of each other, which is not always common with personal trusts. Often purchases and sales are pending in operating accounts and cash may be available from this source. Lastly, in some cases related accounts with the same beneficiaries may have available funds. In the ordinary course of affairs there should be no overdrafts, however, they do occur at times with good reason. It is the examiner's task to identify "true" overdrafts and establish the reason for their existence and duration. Good internal control procedures, including review and approval of large or aged overdrafts, should reduce their number and amount. Habitual or indiscriminate granting of overdrafts may be indicative of a failure to properly time investments or meet account needs, otherwise they may be a substitute for a permanent interest-bearing loan.